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No. 247
No. 248

IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

FEDERAL POWER COMMISSION,
Petitioner,

v.

UNITED GAS PIPE LINE COMPANY
Respondent.

MEMPHIS LIGHT, GAS AND WATER DIVISION,
Petitioner,

v.

UNITED GAS PIPE LINE COMPANY,
Respondent.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

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BRIEF FOR RESPONDENT IN OPPOSITION

To The Honorable Supreme Court of the United States:

Respondent, United Gas Pipe Line Company, files this Brief in Opposition to the Petitions for Writ of Certiorari filed by the Federal Power Commission and by Memphis Light, Gas and Water Division to review the judgment of the United States Court of Appeals for the Fifth Circuit (388 F.2d 385) entered January 10, 1968 in connection with its decision of the issue remanded by this Court in *Federal Power Commission* v. *United Gas Pipe Line Co.*, 386 U.S. 237.

QUESTIONS PRESENTED

1. Whether the Court of Appeals erred in finding that United's petition for rehearing to the Commission was "sufficiently detailed and specific" to preserve for appellate review under Section 19(b) of the Natural Gas Act the remanded issue of whether "the Commission, in applying its tax allowance formula, erroneously failed to recognize and to take account of the fact that United has both jurisdictional and non-jurisdictional activities and income"?

2. Whether upon application of the tax allowance formula the Commission failed to make a separation of United's jurisdictional and non-jurisdictional activities and income and to offset non-jurisdictional losses against non-jurisdictional income?

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act appear in the Commission's petition at pp. 3-5.

STATEMENT

This is the second time this case has been before the Court. The relevant background facts are set forth in *Federal Power Commission* v. *United Gas Pipe Line Company*, 386 U.S. 237, and need not be repeated here. In its prior opinion, this Court held that the Commission did not exceed its statutory powers when it determined the income tax allowance in a pipeline company's cost of service for ratemaking purposes by using the actual consolidated tax paid by the pipeline and its affiliated companies. In particular, the Court approved the "tax allowance formula" which the Commission had devised in *Cities Service Gas Co.*, 30 FPC 158 for determining the proper allowance for federal income taxes to be included in a

pipeline company's cost of service where the pipeline has joined affiliated companies in filing consolidated federal income tax returns.[1] However, the Court reiterated that "Ratemaking is, of course, subject to the rule that the income and expenses of unregulated and regulated activities should be segregated" (386 U.S. at 243). In this connection the Court pointed out that under the Commission's tax allowance formula unregulated losses must be first set off against unregulated income so that "Only if 'unregulated' losses exceed 'unregulated' income is the regulated company deemed to have enjoyed a reduction in its taxes as a result of the consolidated return." (386 U.S. at 245). Having sustained and construed the Commission's formula, the Court remanded the case for the Court of Appeals to decide whether the Commission had properly applied its formula, stating:

> "It is said here that the Commission, in applying its tax allowance formula, erroneously failed to recognize and to take account of the fact that United has both jurisdictional and non-jurisdictional activities and income. Although this is a matter which might affect the results achieved in application of the Commission's formula, it is one to which the Court of Appeals has not addressed itself, and we think it appropriate for the issue to be raised there if the parties are so inclined." (386 U.S. at 247).

On remand, the Court of Appeals found that the Commission had not properly applied its tax allowance formula. In a thorough opinion, the court considered and correctly disposed of the arguments now urged by the Commission

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[1] In that case, the Commission stated that the companies joining in a consolidated tax should be divided into "regulated" and "unregulated" groups, and certain of those companies should be further divided into regulated and unregulated parts, because such companies actually conducted both types of operations.

and Memphis in support of their petitions for certiorari. By reference to specific language in United's petition for rehearing to the Commission, the court found that United's challenge of the application for the Commission's tax allowance formula was "sufficiently detailed and specific to permit review" under Section 19(b) and noted that to hold otherwise "would make pleading an end unto itself" (388 F.2d at 388). Further, it was noted that the issue of the proper application of the Commission's consolidated tax allocation formula was remanded for decision despite the fact that during oral argument before this Court, the Commission had claimed that such issue was not open for review because it was not raised in United's petition for rehearing. As to the remanded issue, the Court of Appeals found that in applying the tax allowance formula for computing United's tax allowance the Commission had failed to make a separation between regulated and non-regulated costs and revenues. The Court pointed out that such separation was a fundamental ratemaking principle which had been recognized in *Panhandle East. P. L. Co.* v. *Federal Pow. Com'n.*, 324 U.S. 635[2] and reaffirmed by this Court in its opinion in this case. The Court of Appeals also noted that paradoxically the Commission had followed the principle of separation "for the purpose of allocating costs between jurisdictional and non-jurisdictional sales of United, but ignored it in computing its tax allowance" (388 F.2d at 389).

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[2] In *Panhandle Eastern P. L. Co.* v. *Federal Pow. Com'n.*, the Court stated (324 U.S. at 641):

> "We agree that the Commission must make a separation of the regulated and unregulated business when it fixes the interstate wholesale rate of a company whose activities embrace both. Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the Act."

The Court of Appeals held that in order to recognize and take account of United's jurisdictional and non-jurisdictional activities and income the Commission should have made a separation of the regulated and unregulated components of United as it did with respect to the production company affiliates in the *Cities Service* case. The court stated if such a separation were made, ". . . a proper tax allocation for federal income taxes can be made for use in the cost of service of United within the principles determined by the Supreme Court when it reviewed our original decision." (388 F.2d at 391). It found that there was ample evidence of record by which such a separation could be made and that the separation would affect the results achieved in application of the tax allowance formula as this Court had predicted it might. Accordingly, the Court of Appeals remanded the case to the Commission with instructions to recompute United's federal income tax allowance by dividing the income of United into regulated and unregulated components and offsetting all unregulated tax losses against unregulated income. It also pointed out that there was a dispute as to the appropriate amount of unregulated tax losses since Petitioners contended that the tax losses of certain of United's affiliates were not entirely attributable to non-jurisdictional business.[3] The court stated that "This is a matter which the Commission should resolve when its final order, consistent with this opinion, is rendered." (388 F.2d at 392, fn. 6).

REASONS FOR DENYING THE WRIT

1. The two issues raised in the petitions in this case are *sui generis* to United and the facts of this case. Neither issue has any general applicability or importance beyond the context of this case. The first issue concerns Petitioners'

[3] See 388 F.2d at 391, fn. 6.

claim that the issue remanded by this Court is not open for decision because the issue was not adequately preserved for appellate review in United's petition for rehearing to the Commission. This claim necessitated a determination by the Court of Appeals of the meaning and sufficiency of United's specification of error. In concluding that the issue of the proper application of the Commission's consolidated tax allowance formula was raised in United's petition for rehearing, the court referred to pertinent parts thereof and concluded that they "were sufficiently detailed and specific to permit review" under Section 19(b).[4] The sole effect of the court's determination was to permit United to seek review of the remanded issue. Obviously any determination of the sufficiency or insufficiency of United's specification of error is peculiar to this case. It is patently absurd for the Commission to argue that the meaning of particular language used by United in its petition for rehearing "is important in the administration of natural gas regulation" or that it will have "substantial impact for the conduct of business by federal regulatory agencies." (Com. Pet. pp. 19 and 25).

The second issue likewise has limited application. The Court of Appeals determined that the Commission erred in applying its tax allowance formula in computing federal income taxes to be included in United's cost of service. This determination was predicated solely upon the facts of this case and correspondingly the significance and impact of such determination is confined solely to this case.

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[4] Under Section 19(b) all matters logically and reasonably connected with the language employed in a petition for rehearing before the Commission may be reviewed by the appellate court. *Nat. Gas Pipeline Co.* v. *FPC* (7 Cir. 1941) 120 F.2d 625, rev'd on other grounds (1942) 315 U.S. 575; *Nat. Gas Pipeline Co.* v. *FPC* (3 Cir. 1958) 253 F.2d 3, cert. den. (1953) 357 U.S. 925; *California* v. *FPC* (9 Cir. 1965) 353 F.2d 16; *Public Utility District No. 1* v. *FPC* (9 Cir. 1957) 242 F.2d 672.

However, the Commission contends that the decision of the Court of Appeals "creates continuing uncertainty as to the validity and utility of the formula this Court approved before remanding the case to the Fifth Circuit" (Com. Pet. p. 14). Evidently the Commission has failed or refused to understand what the Court of Appeals did before remanding the case for the Commission to make further factual determinations. The court below did not change the Commission's tax allowance formula; it did not enunciate any new legal or regulatory principles of law. Instead, the court carefully followed the prior decision of this Court. The Court of Appeals recognized fully this Court's approval of the Commission's formula, and it did no more than review the application made of the formula to United in light of the interpretation made by this Court that application of the formula includes separation of regulated and unregulated activities and income. This principle of separation is not new. It had been recognized by this Court as early as 1945[5] and was expressly reaffirmed by this Court's prior decision in this case (386 U.S. at 243). In holding that the Commission erred in applying its tax allowance because no separation of United's regulated and unregulated activities and income had been made, the Court of Appeals did nothing more than require the Commission to apply its formula "within the principles determined by the Supreme Court when it reviewed our original decision." (388 F.2d at 391). The Commission also asserts that the "same question" of the proper application of its tax allowance formula may arise in any rate-making proceeding involving pipelines which participate in consolidated tax returns, and also in the determination of rates of electric companies under the Federal Power Act (Com. Pet. p. 25).

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[5] *Panhandle East. P. L. Co.* v. *Federal Pow. Com'n.*, 324 U.S. 635 (1945).

If this is true, it is not because of the decision of the Court of Appeals on the remanded issue in this case, but because the separation of regulated and unregulated activities and income is fundamental to the determination of rates for any utility. In its original opinion in this case, this Court pointed out that all facets of ratemaking, not just the computation of income taxes, were "subject to the rule that the income and expense of unregulated and regulated activities should be segregated" (386 U.S. 243). Whether an application of the Commission's tax allowance formula comports with this rule will necessarily depend on the facts of each case. The fact that the Court of Appeals held that the Commission's application of its formula to United failed to follow the rule does not portend that the Commission or other regulatory bodies will likewise fail to make a separation between regulated and unregulated costs and revenues in future cases under entirely different facts and circumstances.

2. The petitions should not be granted because there are unanswered factual determinations to be made by the Commission pursuant to the remand of the Court of Appeals. In calculating United's federal income tax allowance on remand the court held that the Commission is to (1) "divide the income of United, a mixed company, into regulated and unregulated components," (2) "offset all unregulated net tax losses against unregulated income," and (3) determine if any portion of the net taxable losses ($3,893,980) of United's affiliates[6] is attributable to their regulated activities. The Court of Appeals correctly determined, and apparently Petitioners do not dispute, that the evidence of record permits the separation of United's jurisdictional and non-jurisdictional activites and income

[6] Union Producing Company and United Overseas Production Corporation.

and the offsetting of non-jurisdictional losses against non-jurisdictional income. However, it appears that additional evidence may be required in connection with Petitioners' contention that a portion of the losses of United's affiliates are attributable to regulated activities. Upon making these factual determinations the Commission will be able to ascertain "what portion of the single consolidated tax liability belonged to United" (386 U.S. at 243). Until these factual determinations have been made by the Commission, the results achieved by application of the Commission's formula pursuant to the remand of the court below are unknown.[7] Accordingly, review by this Court is decidedly premature. In effect, at present there is no final order for this Court to review.

3. The Court of Appeals was clearly correct in finding that the Commission had not properly applied its tax allowance formula. Indeed, the Commission admitted to this Court that it may not have properly applied its formula. Thus, in its original petition for certiorari in this case the Commission stated:[8]

> "There may indeed be problems in the application of the particular formula used by the Commission in this case, a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group."

It is undisputed that in applying its tax allowance formula the Commission did not make a separation of the regulated

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[7] Although the Court of Appeals noted that it is apparent the income from the unregulated component of United was sufficiently large to absorb all unregulated tax losses, it did not attempt to apply the Commission's tax allowance formula but remanded with instructions for the Commission to make the the required factual determinations.

[8] See 388 F.2d at 391, fn. 4.

and unregulated components of United[9] It was for this reason that this Court, after sustaining the Commission's authority to adopt a consolidated tax allocation formula, remanded the case with instructions for the Court of Appeals to determine whether "the Commission, in applying its tax allowance formula, had erroneously failed to recognize and to take account of the fact that United has both jurisdictional and non-jurisdictional activities and income." (386 U.S. at 247). On remand, the Court of Appeals found that the Commission had not made a separation of United's jurisdictional and non-jurisdictional activities and income in the application of the tax allowance formula which this Court had approved. In directing the Commission to make such a separation, the Court of Appeals was merely following the interpretation this Court had placed on the application of the formula in its earlier opinion that: "Ratemaking is, of course, subject to the rule that the income and expense of unregulated and regulated activities should be segregated." (386 U.S. at 243). Such separation is consistent with and, in fact, is required by this Court's *Panhandle Eastern* decision, *supra*,[10] and by the Commission in the *Cities Service* case, where in promulgating the tax allowance formula it stated (30 FPC at 162):

> "However, we agree with Cities Service that the fundamental rate making principle governing our dis-

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[9] In Opinion 428 the Commission states (II R 41): "United is largely a regulated company, and we shall designate it as such for the purposes of these computations."

[10] Petitioners can find no way around the requirement of separation under the *Panhandle Eastern* decision. Therefore, they assert it was "at the heart of the Tenth Circuit's decision that held the *Cities Service* formula invalid" and in deciding the instant case, this Court "rejected that view" (Com. Pet. p. 24). Contrary to Petitioners, this Court did not impliedly overrule *Panhandle*, but relied on it to "support the power and the duty of the Commission to limit cost of service to real expenses" (386 U.S. at 242).

position of this issue requires a separation between regulated and unregulated costs and revenues. *This principle controls our allocation of other costs which are jointly incurred by regulated and unregulated companies, or departments within the same company, and is controlling here.* If we were to allocate the consolidated system tax return among all profit companies including those in whole or part engaged in unregulated activities, there would be no sound reason for refusing to fix jurisdictional rates at a level sufficient to make up any real losses these companies might suffer." (Emphasis supplied).

4. Petitioners do not challenge the validity of the separation principle but advance several arguments why it should not be applied in computing United's allowance. First, they contend that separation should not be required in this case because the Commission did not make a separation of the regulated and unregulated components of Cities Service Gas Company in the very proceeding in which the tax allowance formula was devised. However, this argument is an obvious non sequitur because *application* of the formula in *Cities Service* is not dispostive of the manner in which the Commission's tax allowance formula should be applied to United. Further, in the *Cities Service* case the Commission made a separation of the taxable income of two producing affiliates[11] of Cities Service Gas Company. In the same vein Petitioners argue that a separation of Cities Service Gas Company could have been made because the record in the *Cities Service* case contained the same data on which the Commission has been directed to make a separation of United's jurisdictional and non-jurisdictional activities and income. This argu-

[11] Cities Service Oil Company and Cities Service Production Company, both of which make sales of natural gas in interstate commerce and, therefore, are classified as "natural gas companies" under the Natural Gas Act.

ment is difficult to reconcile with the statement in the Commission's decision that "Cities Service . . . failed to present any evidence upon which to make such an allocation." (30 FPC at 163). In this connection it is significant that the revenue figures for Cities Service Gas Company quoted in the Commission's brief (p. 20) are from a source other than the record in that case. Further, the existence or non-existence of certain data in the *Cities Service* record in no way explains why the principle of separation should not be applied in this case.

Petitioners also assert that United's non-jurisdictional income is to a large extent derived from direct interstate sales of gas to industrial users. While they admit these sales are not "directly within the Commission's ratemaking jurisdiction," they contend that the interstate transportation of gas for such sales is subject to the Commission's certificate jurisdiction and therefore interstate industrial sales should be considered in the "regulated" category and not in the "unregulated" category which the Court of Appeals accepted (Com. Pet. pp. 22-23). The Court of Appeals correctly rejected this argument saying "certificate jurisdiction is not the same as . . . rate jurisdiction . . . and regulation here is *rate* regulation." (at 388 F. 2d at 388).[12] Moreover, 27.98% of United's taxable income during the period in question ($29,460,417), was from wholly uncertificated, wholly unregulated activities, more than enough to absorb the unregulated tax losses ($3,893,980) of United's affiliates (388 F. 2d at 388).

The Commission further contends that the required separation of the regulated and unregulated components of

[12] Even if the Commission were correct, the remand required by the Court of Appeals would still be necessary in order to make a separation of United's other non-jurisdictional income and activities.

United is at odds with its "discretionary" authority to adopt a formula that allocates tax liability. (Com. Pet. p. 24). However, nothing in the decisions of this Court or of the Court of Appeals on remand denies the Commission's authority to adopt such a formula. What these decisions say is that, in applying the formula which was adopted, the Commission is required to separate jurisdictional and non-jurisdictional activities and income. This is exactly how the Commission told the Court of Appeals for the Tenth Circuit the tax allowance formula would be applied. In its brief to that court upon appeal in the *Cities Service* case, the Commission said:

> "Concluding that a system of several affiliated corporations filing a consolidated return is in essentially the same position as if it were such a single corporation, the Commission overruled its staff's contentions that no distinction should be made between regulated and unregulated components of the system. It held instead that all of the unregulated corporations (together with the unregulated *portions of regulated companies*) should have their profits and losses netted before *any net* was allocated to the regulated corporation's business (*or regulated portions*)." (p. 9, FPC Brief, No. 7538 USCA 10 Cir, *Cities Service Gas Company, et al vs. FPC* dated March 23, 1964) Emphasis added.

Thus this Court's prior decision and remand, the Court of Appeals' decision on remand, and the Commission's representation to the Tenth Circuit are in accord in requiring separation in the application of the formula to United. Of course, the Commission does not have "discretion" to ignore this fundamental ratemaking principle in the application of its formula.

Finally, Petitioners fall back on the argument that if the required separation is made the consuming public will be required to pay excessive rates because United's tax allowance will be increased over the tax allowance originally calculated by the Commission[13] although United will not incur an equivalent out-of-pocket expense.[14] The fatal defect in these bootstrap arguments is that they obviously assume the answer they seek to justify, i.e., assume that the tax allowance resulting from the Commission's original allocation was lawful and equitable and that any higher tax allowance is excessive. The very reason for requiring separation of regulated and unregulated components of a company when fixing its rates is to make certain that costs and revenues are correctly assigned or equitably apportioned and that each component "bears its just share of corporate costs *but no more*" (Com. Pet. p. 24). Unless such separation is made "the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business," and vice-versa. *Panhandle East. P. L. Co.* v. *Federal Pow. Com'n., supra.* Therefore, in this case a separation of United's jurisdictional and non-jurisdictional activities and income is necessary to insure an equitable allocation of the consolidated taxes paid by United and affiliated companies.

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[13] The amount of the alleged increase is not clear and will have to await the factual determinations to be made by the Commission on remand. The Commission contends that United's rates will be increased by more than $250,000 per year (Com. Pet. p. 24).

[14] Com. Pet. pp. 24-25, Memphis Pet. p. 11.

CONCLUSION

For the foregoing reasons it is respectfully submitted that the petitions for a writ of certiorari should be denied.

Respectfully submitted,

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PROOF OF SERVICE

I, David T. Searls, one of the attorneys for Respondent herein and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 10th day of August, 1968, I served copies of the foregoing Brief for Respondent in Opposition by mailing copies thereof to counsel for the Federal Power Commission and for Memphis Light, Gas and Water Division, Petitioners in Nos. 247 and 248, respectively.

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DAVID T. SEARLS